R5650-2A

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

NO. 2B
January 18, 1985

IN THIS ISSUE:

Nakasone Issues Qualified Support for "Star Wars" Initiative 1

The Yen: A Look Backward and Forward 3

Financial Market Liberalization Moves Ahead in Japan 5

White House Shuffle: Little Impact on Japan 7

Upcoming Bilateral Market Access Talks to Focus on Four Areas 9

Nakasone Issues Qualified Support for "Star Wars" Initiative

Prime Minister Yasuhiro Nakasone, who has expressed his "understanding" of President Reagan's Strategic Defense Initiative (SDI) -- the so-called "Star Wars" strategy -- may have embroiled himself in another defense-related controversy at home. The issue is a further example of Japan's sensitivity to the collective security debate, including domestic defense spending and the use of its technology in advanced weapons systems.

American officials have sought allied support for SDI to give the program credibility at home and negotiating leverage with the Soviets. Mr. Nakasone has neither condemned nor embraced it. His hesitance may stem from popular fears that backing the program will ultimately translate into direct Japanese involvement, another step toward what many defense critics see as an increasingly prevalent pattern linking Japan with U.S. defense and security concepts. The Japan Socialist Party (JSP) has been particularly critical of

The Yen: A Look Backward and Forward

The yen-dollar exchange rate is one rough spot in U.S.-Japan relations that has resisted the best ameliorative efforts of policymakers. Last year was no exception, and the outlook for 1985 is no better despite the much-hailed yen-dollar agreement signed last summer. The root of the problem is that the exchange rate is determined by a multitude of factors, many of which are beyond the control of either government.

The first half of 1984 was characterized by the yen's advance and subsequent retreat against the dollar. The yen had gained 4.3 percent over its initial 1984 rate by the end of March. By the end of June, however, it had surrendered its gains and then some (see table). The causes of the first-quarter surge were not wholly economic: the resurgence of the U.S. economy combined with sluggish Japanese growth should have driven the yen down. Speculators apparently bet that the dollar was at unsustainably high levels in early 1984 and moved into yen, pushing it up. As the U.S. economy continued to barrel along at 7 to 10 percent quarterly growth rates, it became increasingly clear that the speculators had guessed incorrectly, and the weight of economic forces drove the yen down.

The dollar's upward march against the yen continued throughout the second half of 1984 with almost no pause. In fact, many traders began to speculate against the yen as U.S. long- and short-term interest rates remained far above those obtainable in Japan. The dollar moved up sharply in July, and then held steady for several months before making another big advance in December. The year ended with the dollar worth Y251.10, Y17.50 or 7.5 percent more than on 1984's first trading day.

Japanese officials found the yen's erosion uncomfortable at best, even though they were correct in attributing it to high U.S. interest rates and import-hungry American consumers -- both factors beyond Tokyo's control. Japan was not alone in experiencing a weakening currency. In fact, the yen was the most stable of the major currencies. On New York's interbank spot market, the West German mark and French franc lost over 13 percent during 1984, the lira 14 percent, the Swiss franc 16 percent, the British pound 20 percent and the Canadian dollar 39 percent (see table). The return of solid growth in the Japanese economy, in contrast with other industrial countries, blunted the dollar's upward motion.

More worrisome in Japanese monetary officials' eyes was the volatility of the Tokyo exchange markets, particularly in November and December. Day-to-day changes of a full yen or more became almost commonplace in the last months of 1984. The swings were not caused by heavy speculation, as daily trading volumes were moderate in November and light in December, but by uncertainties about the direction of the U.S. economy and interest rates. (December's light trading did amplify slight changes, however.) The Bank of Japan constantly stated its willingness to intervene in the marketplace when things threatened to get out of hand and consistently backed its warning with action.

Monthly Yen-Dollar Exchange Rates* and Average Daily Trading Volumes, 1984

(in yen per dollar and millions of dollars)

	Rate	Volume		Rate	Volume
January	Y234.8	$1,030	July	Y245.5	$1,671
February	233.5	1,130	August	241.3	1,421
March	224.7	1,820	September	245.5	1,510
April	226.0	1,240	October	245.3	1,525
May	231.5	1,712	November	246.3	1,452
June	237.5	1,677	December	251.1	1,088

*End-of-month quotation on the Tokyo interbank spot market.

Foreign Exchange Rates*, 1984

(in units of foreign currency per dollar)

	December 30 1983	January 1 1984	December 31 1984	January 1 1985
British pound	0.6875	0.7010	0.8627	0.8703
Canadian dollar	0.8031	0.8023	1.3200	1.3222
French franc	8.3375	8.4700	9.6250	9.7050
Italian lira	1656.50	1678.00	1933.00	1947.00
Japanese yen	231.60	233.75	251.40	251.75
Swiss franc	2.1800	2.2185	2.6000	2.6180
West German mark	2.7280	2.7650	3.1500	3.1730

*Close-of-day quotation on the New York interbank spot market.

Japanese monetary officials have also supported the 1984 yen-dollar agreement with both words and actions, even if not to the complete satisfaction of the Reagan administration. The pact is aimed at altering the structure of the Japanese monetary system, which Americans claim has been preventing wider use of the yen (see JEI Report No. 22B, June 8, 1984). The U.S. government's expectations have proven to be overly optimistic, and there are even questions about the agreement's ultimate impact. It is still too early to make an assessment, though, especially since the more far-reaching reforms have not yet been implemented. What is clear is that financial flows are the dominant factor in setting exchange rates: last year's staggering U.S. merchandise trade deficit had no visible dampening effect on the dollar's rise. Hence, in focusing on structural factors that influence financial flows, U.S. policymakers are at least pulling the right levers.

The outlook for 1985 remains very cloudy. The majority of analysts see U.S. interest rates and growth moderating by mid-year, reducing the gap between domestic and Japanese long-term interest rates. This scenario envisions the dollar's gradual fall -- a point with which some observers disagree. Noting the volatility of exchange markets last year, these dissenters fear the rapid

collapse of the dollar and ensuing chaos. Another vocal minority claims the opposite will happen: the greenback will stay at current levels or even rise. Should the U.S. economy slow down, it is argued, investment opportunities in the United States will still be preferable to those available in other countries. Japan could be the exception to this situation due to its recovering economy. This -- plus help from capital market liberalizations -- should be enough to keep the yen from falling much further. Whether the yen will rise against the dollar is another question, however.

Jon Choy

Financial Market Liberalization Moves Ahead in Japan

Satoshi Sumita, the new governor of the Bank of Japan (BOJ), rang in the new year by pledging to continue liberalizing Japan's capital markets, referring to it as a "natural direction." It appears that the hallmark of his five-year term will be the shepherding of the Japanese financial system through a transition period. He has set himself the task of pursuing rapid financial liberalization while maintaining the stability of the system. The BOJ must also undergo fundamental changes, in his view, which will add to the already gargantuan task.

The Euroyen market, significantly changed in 1984, is scheduled to undergo further reform this year. December issues of Euroyen bonds by foreign entities totalled nearly half of all previous outstanding Euroyen issues. The large increase was a result of measures opening this instrument to foreign companies in December. Seven companies accounted for Y145 billion ($592 million) of the Y177 billion ($722 million) worth of Euroyen bonds offered. An even larger expansion is seen after April 1, 1985 when the credit rating requirement for issuers is lowered to single-A.

The market should also receive a boost when the government implements its early January decision to end the 20 percent withholding tax on Euroyen interest paid to foreigners. U.S. officials argued that the tax made Euroyen offers unattractive, blunting the force of the reforms. While convinced that the tax repeal is unfair to Japanese purchasers (who currently hold the vast majority of outstanding issues), Tokyo agreed to the change in hopes of further spurring the market's development.

The domestic market for foreign-issued yen-denominated bonds has also been very active, with Y90 billion ($367 million) in new issues offered in December. The plan to allow foreign firms to issue convertible yen bonds is generating considerable excitement in a market already riding high since the relaxation of issuance rules for domestic firms last year. The Ministry of Finance (MOF) supports the changes, both because they will make the Tokyo bond market more competitive with established financial centers as well as to provide more flexible financing to corporations.

It is possible that the regulations for foreign firms being drawn up by MOF could be more lenient than those applied to domestic firms. For example, foreign issues may not have to maintain certain dividend levels or follow certain payment practices when the bonds are converted into stock.